Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Harman	Analyst:	Angela Raygoza	Bill Number:	SB 928
Related Bills:	See Legislative History	Telephone:	845-7814	Introduced Date:	February 23, 2007
		Attorney:	Doug Powers	Sponsor:	

SUBJECT: Cancer Research Expenses Credit/20% Of Excess Qualified Expenses/Conformity to Election of Alternative Incremental Credit

SUMMARY

Under the Personal Income and Corporation Tax laws, this bill would do the following:

- Allow a tax credit for qualified donations to specified cancer research institutions,
- Increase the amount of the qualified Research Expense credit, and
- Fully conform to the federal alternative incremental research credit (AIRC).

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to ensure medical organizations remain in California to continue research and stimulate the economy.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

<u>Charitable Contributions</u>

Current federal and state tax laws allow a taxpayer to claim charitable contributions as an itemized deduction. Deductions are allowed for monetary charitable contributions or gifts of property to qualified federal, state, or local governments; to organizations formed for religious, charitable, educational, scientific, or literary purposes; or to organizations for the prevention of cruelty to children or animals.

Board Position:			Department Director	Date
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Current federal and state tax laws place limitations on charitable contributions. The limitations vary from 20%, 30%, or 50% depending on the individual's AGI and the amount of contributions made, the types of organizations that receive the donations, and the type of property donated. If an individual's charitable contributions are limited, the excess may be carried over for five years.

Corporate taxpayers are entitled to claim charitable contributions up to 10% of the corporation's taxable income, without regard to the charitable contribution. Any contributions in excess of the 10% limitation may be carried over for five years.

Research Expense Credit

Existing federal law allows taxpayers a research credit in the amount of 20% of the excess of qualified research expenses for the taxable year over a base amount. The research credit is designed to encourage companies to increase their research and development activities.

To qualify for the Research Expense credit, research expenses must qualify as an expense or be subject to amortization, be incurred in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new or improved business component. This is a product, process, technique, formula or an invention to be sold, leased, or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; or development of any plant, process, machinery, or technique for the commercial production of a business component, unless the process is technologically new or improved.

The federal credit does not apply to any expenses paid or incurred after December 31, 2007.

California conforms to the federal credit with the following modifications:

- ♦ The state credit is not combined with other business credits.
- ♦ Research must be conducted in California.
- ♦ The credit percentage for qualified research expenses in California is 15% versus the 20% federal credit.
- ♦ The credit percentage for basic research payments in California, limited to corporations, is 24% versus the 20% federal credit.
- ♦ The California AIRC rates are 1.49%, 1.98%, and 2.48% versus the federal rates of 3%, 4%, and 5%, respectively.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent without regard to whether the federal credit is operative.

<u>THIS BILL</u>

<u>Cancer Research Donations Credit</u>

This bill would provide a credit in an amount equal to 25% of the amount of qualified donations made by a qualified taxpayer during the taxable year to a qualified cancer research institution.

This bill would define the following terms:

- "Cancer research" is research with respect to the cause, cure, treatment, early detection, and prevention of cancer.
- "Qualified cancer research institution" includes, but shall not be limited to, any center, company, foundation, organization, program, or university, located in this state, that allocates at least 20% of its resources to conduct cancer research.
- "Qualified donations" means the aggregate amount of donations, not to exceed $500,000, made by a qualified taxpayer to a qualified cancer research institution during a taxable year.
- "Qualified taxpayer" is a taxpayer, located within this state, that creates, manufactures, distributes, sells, produces, or plays a significant role in the areas of medical technology, biotechnology, or pharmaceuticals.

This bill would specify a cancer research institution receiving a donation under this provision shall use the donation only for the purpose of conducting cancer research.

This bill would allow the excess credit to be carried over to the following year, and succeeding years, until the credit is exhausted.

<u>Research Expense Credit</u>

This bill would raise the credit for increasing qualified research expenses from 15% to 20% for taxable years beginning on or after January 1, 2007.

In addition, this bill would fully conform to the federal AIRC rates for taxable years beginning on or after January 1, 2007.

<u>IMPLEMENTATION CONSIDERATIONS</u>

While this bill would define the terms "cancer research" and "qualified cancer research institution," the department lacks the expertise to determine whether either would meet the criteria provided in the definitions. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. It is recommended that the author amend the language to specify an entity that would be responsible for certifying that the donation made by a taxpayer meets the requirements provided for in this bill.

The bill would define “qualified donations” as the aggregate amount of donations. The bill fails to specify whether donations would include cash or property or both. If donations other than cash are accepted, it is unclear how the value would be determined. The author may wish to amend the bill to specify what types of donations qualify and require documentation that would establish the value of donations other than cash.

The bill would require that the qualified research institution use the donation only for conducting cancer research, but lacks language that would provide a consequence for failing to do so. The author may wish to amend the bill to include an enforcement provision to ensure the donations are used as the author intends.

TECHNICAL CONSIDERATION

This bill would define “cancer research” as research with respect to the cause, cure, treatment, early detection, and prevention of cancer. Usage of “and” infers that the research must include all of the criteria to qualify. If the author’s intent is to allow the credit for donations made for purposes of any cancer research, the bill should be amended to use “or” in place of “and.”

LEGISLATIVE HISTORY

AB 751 (Lieu, 2007/2008) and AB 359 (Harman, 2007/2008) would, among other things, increase the qualified research expense credit and conform to the federal AIRC for taxable years beginning on or after January 1, 2007. These bills are currently in the Assembly Revenue and Taxation Committee.

AB 2032 (Lieu, 2005/2006) would have increased the amount of the qualified research expense credit from 15% to 18%. AB 2032 failed to pass out of the Assembly Revenue & Taxation Committee.

AB 2567 (Arambula, 2005/2006) would have conformed the amount of the qualified research expense credit to the amount allowed at the federal level. AB 2567 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 483 (Harman, 2001/2002) and SB 1165 (Brulte, 2001/2002) would have increased the credit for qualified research expenses from 15% to 20%. AB 483 was held in the Senate Revenue and Taxation Committee. SB 1165 failed to pass out of the originating house by the constitutional deadline.

AB 511 (Stats. 2000, Ch. 107) increased the state credit for qualified research expense from 12% to 15%.

OTHER STATES' INFORMATION

Cancer Research Donations Credit

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. These states have no credit comparable to the credit this bill would allow.

Research Expense Credit

Florida allows corporate taxpayers to claim a corporate income tax credit for tax years beginning on or after January 1, 2007, for certain "eligible costs" for renewable energy technologies investment. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in *Illinois*. The credit equals 6 ½% of the qualifying expenditures.

Massachusetts allows corporate taxpayers to claim an income tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is 15% of the basic research payments and 10% of qualified research expenses conducted in *Massachusetts*.

Minnesota allows corporate taxpayers a credit equal to 5% for qualified research expenses up to $2 million. The amount of the credit is reduced to 2.5% for expenses exceeding the first $2 million.

Michigan allows corporate taxpayers a credit for pharmaceutical research and for a percentage of the compensation for services paid by the taxpayer that is engaged in research and development of a hybrid system for propelling motor vehicles. An eligible taxpayer may claim a credit against the Single Business Tax equal to 6.5% of the excess of qualified research expenses paid in the tax year that relate to pharmaceutical-based business activity in *Michigan* paid during the three immediately preceding tax years.

Beginning in 2005, *New York* allows a credit for qualified emerging technology companies. The amount of the credit is equal to the sum of 18% of the cost of research and development property, 9% of the qualified research expenses paid or incurred by the taxpayer, and the costs of high-technology training expenditures paid or incurred by the taxpayer. The credit is limited to $250,000 per taxable year.

FISCAL IMPACT

The bill would not impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The bill would result in the following revenue losses:

Estimated Revenue Impact of SB 928 Effective for Tax Years BOA 1/1/2007 Enacted by 6/1/2007 ($ in Millions)				
	2007-08	2008-09	2009-10	2010-11
Cancer research credit	-$25	-$30	-$35	-$35
Increased qualified Research Expense credit	-$125	-$160	-$170	-$175
Increased AIRC rates	-$5	-$5	-$5	-$5
Total	-$155	-$195	-$210	-$215

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Cancer Research Donations Credit

Qualified donations from various sources are estimated and extrapolated based on a study prepared for the National Cancer Policy Board.[1] For taxable year 2008, qualified donations are estimated to be $200 million. Most qualified donations come from corporate sources. In the last seven years, qualified donations were assumed to grow at an average growth rate of 7% per year for corporate taxable income. The cancer research donations credit usage rate is assumed to be 60%. The revenue impact of the cancer research donations credit for fiscal year 2008 is estimated to be $30 million ($200 million qualified donations x 25% credit rate x 60% credit usage rate =$30 million).

[1] Michael McGeary and Michael Burstein, *Sources of Cancer Research Funding in the United States*, Report prepared for the National Cancer Policy Board, Institute of Medicine, June 1999.

Research Expense Credit

The above revenue impact was estimated as follows. First, the revenue loss due to an increased regular qualified Research Expense credit rate was estimated using a corporate credit and personal income tax model based on the 2001-04 Franchise Tax Board credit samples.

For each corporation in the sample of corporate tax returns, the tax liabilities under the current and proposed laws were simulated taking into account the entity's taxable income, net operating losses, qualified Research Expense credit, the Research Expense credit rates, and carryover credits. Not all the additional research credit generated in a particular year would be used in that year. Taxpayers without sufficient tax liability would not be able to fully use the additional credit. Unused credit will be carried forward to subsequent years. The unused corporate qualified Research Expense credit is currently in excess of $8 billion. Using the department's tax model, results have shown that the proposed increased qualified Research Expense credit rate would generate $580 million additional credit in 2004. However, the tax modeled showed only $115 million of this amount could be used in reducing tax liability for the same tax year. The AIRC currently accounts for about 2% of qualified Research Expense credit claimed. The percentage increases in the AIRC credit rates under this bill are much higher than that of the regular Research Expense credit rate. Therefore, it is assumed that the revenue loss due to higher AIRC rates would be about 4% of the loss from the increased qualified Research Expense credit rate.

Next, the results were expanded from sample to corporate population and extrapolated to later years. The extrapolation was based upon the latest Department of Finance forecast for corporate profits.

The personal income tax revenue impact in future years as a fraction of the corporate revenue impact is assumed to be equal to the ratio of personal income tax qualified Research Expense credits to corporate qualified Research Expense credits in 2004. This ratio in 2004 was 4%.

The revenue impacts of the three provisions of this bill; higher qualified Research Expense credit rate, higher AIRC credit rate, and cancer research donations credit; for the 2008 taxable year are estimated to be revenue losses of $135, $5, and $30 million respectively. The tax year estimates are converted to fiscal year revenue estimates reflected in the above table. For instance, the 2007/08 cash flow estimate of a revenue loss of $155 million consists of a $90 million loss for 2007, plus $65 million loss for 2008 due to reduced estimated tax payments.

POLICY CONCERNS

The cancer research donation credit provision of this bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense. Generally, credits contain a provision stating that the credit would be allowed in lieu of any other deduction that may be available for the same costs.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

LEGAL IMPACT

This bill would require taxpayers to target certain investment incentives in the state to qualify for the deduction. This requirement may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

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